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Business Bankruptcy and Restructuring: 2015/2016

A year ago, we noted that corporate defaults and bankruptcy filings remained at relatively muted levels, amid continuing low interest rates and well-performing credit markets.

In 2015, those trends began to reverse. In December, the Federal Reserve increased interest rates for the first time since 2006, albeit modestly. During the second half of the year, credit and commodity markets proved increasingly volatile, with spreads on CCC-rated bonds spiking nearly 250 basis points. There were 75 chapter 11 filings in 2015 involving debt of $100 million or more, the highest number since 2010. In addition, near the end of the year, several investment funds specializing in high-yield debt suspended redemptions or announced liquidations or closings. While questions remain about the scope and depth of these market challenges — and, in particular, the extent to which the challenges will be limited to the energy industry — market sentiment appears to have shifted.

Looking forward to 2016, we expect many of the trends from 2015 to continue. In particular, low commodity prices continue to create a challenging environment in the oil and gas and related sectors. Retailers will continue to face pressure, including from internet shopping, and in some cases may be compelled to file bankruptcy petitions or liquidate assets. Faced with market volatility and the high costs of bankruptcy, we expect distressed borrowers to continue pursuing out-of-court strategies, including exchange offers (whether public or privately negotiated), bespoke financing arrangements and equity capital infusions. In this environment, and in light of the various strategies being employed, advance planning by debt investors and issuers alike will be as important as ever.

We discuss below several important developments and themes from 2015, as well as expectations for the year ahead.

Rights of Secured Creditors

Last year, we wrote about the *Momentive* decision by Judge Robert Drain of the United States Bankruptcy Court for the Southern District of New York, in which the court held that the debtor could "cram up" secured creditors by distributing replacement notes bearing below-market interest rates and without paying "make-whole" premiums. As has been widely noted, the *Momentive* decision, if upheld on appeal, has the potential to strengthen the position of debtors and unsecured creditors in negotiations and litigation with secured creditors.

In 2015, *Momentive* gained traction both in New York and in Delaware. First, in May 2015, the district court in New York affirmed Judge Drain's *Momentive* decision in all respects. Separately, in the Energy Future Holdings (EFH) bankruptcy in Delaware, Judge Christopher Sontchi found the *Momentive* decision persuasive in a series of rulings denying make-whole payments to noteholders of an EFH subsidiary. Consistent with *Momentive*, the court in *EFH* rejected make-whole claims where the governing indentures did not expressly require payment of such amounts following a bankruptcy default and acceleration. The court reached this conclusion even where, as in *Momentive*, the indenture called for payment of a "premium, if any . . . and any other monetary obligations" upon an event of default.

Secured creditors have appealed the lower court decisions in both *Momentive* and *EFH*. The Second Circuit will likely decide the *Momentive* appeal in 2016. Although creditors can potentially protect their entitlement to make-wholes through more precise drafting, the other aspect of the *Momentive* ruling — namely the ability to refinance debt under a plan at rates far lower than would be available in the market — cannot be easily addressed by contract. Accordingly, depending on the outcome of the appeals, secured creditors will need to account for *Momentive* risk in making credit and pricing decisions, and may be motivated to press for sales or liquidations to avoid being forced to take below-market paper under a chapter 11 plan.

The Trust Indenture Act

In 2015, several decisions by federal courts in New York called into question the ability of companies that issue debt securities governed by the Trust Indenture Act (TIA) — including securities issued in registered offerings — to consummate out-of-court restructurings without the consent of all affected noteholders. Section 316(b) of the TIA protects a noteholder's "right to receive payment" when due from being "impaired or affected" without consent; it has traditionally been understood to prohibit nonconsensual amendments to an indenture that alter the amount owed or the due dates for payment. In *Marblegate Asset Management* v. *Education Management Corp.*, and in several decisions involving Caesars Entertainment Corp., two judges in the Southern District of New York held that "out-of-court restructurings" that diminish a noteholder's practical ability to collect payment, including through asset sales or guarantee releases contemplated by the indenture, may run afoul of section 316(b), even when the issuer's payment obligations are not altered.

The TIA issue raised in these decisions will ultimately be addressed by the Second Circuit Court of Appeals. If the district court decisions are upheld, they will likely inhibit issuers of TIA-qualified securities from engaging in out-of-court restructuring transactions, including some exchange offers, and encourage more bankruptcy filings. The decisions may also lead to fewer registered offerings — a trend that already appears to be taking hold — as companies desiring to maintain flexibility may pursue private issuances.

Puerto Rico

As we write this, the government of Puerto Rico is embroiled in litigation, lobbying, and negotiation on multiple fronts over efforts to restructure Puerto Rico's approximately $70 billion of debt. In June 2015, following a series of credit rating downgrades and amid deteriorating access to credit markets, Governor Alejandro García Padilla announced that the island would not be able to pay all of its debt. In December 2015, the Governor signed an executive order diverting revenue that had been pledged to other creditors in order to pay its general obligation debt. Following the recent default on a $36 million payment due under bonds issued by the Puerto Rico Infrastructure Financing Authority (PRIFA), bond insurers filed a lawsuit to stop the diversion of funds.

By virtue of its legal status as a U.S. territory, rather than a state, Puerto Rico has limited tools available to restructure debts and bind dissenting creditors. Unlike municipalities in the United States (such as Detroit), Puerto Rico's municipalities are not eligible to file for bankruptcy under chapter 9 of the Bankruptcy Code. It is also unclear whether Puerto Rico can enact its own restructuring legislation: In July 2015, the First Circuit Court of Appeals affirmed a district court ruling that the Puerto Rico Public Corporation Debt Enforcement and Recovery Act, which purported to provide a mechanism for Puerto Rico's public corporations to restructure their debts, was preempted by federal bankruptcy law. The Supreme Court has agreed to review the First Circuit's ruling. Notably, even without the benefit of a restructuring statute, the Puerto Rico Electric Power Authority (PREPA) and its main creditors were able to reach agreement in principle in December 2015 to restructure PREPA's debts.

Puerto Rico has been lobbying Congress to allow its municipalities to restructure their debts under chapter 9. The U.S. Treasury Department has gone further, proposing a new territorial bankruptcy scheme that would allow Puerto Rico to restructure both its municipal and its general obligation debts in a single proceeding, while also creating a federal authority to oversee the restructuring. These efforts will likely come to a head in the coming months.

<u>Extraterritorial Reach of the Bankruptcy Code</u>

In our memo dated July 8, 2014, we wrote about a significant decision from Judge Rakoff of the U.S. District Court for the Southern District of New York holding that the trustee overseeing the Bernard Madoff liquidation could not recover transfers made by Madoff's foreign customers to other foreign entities. The court concluded that Congress did not intend for the Bankruptcy Code's fraudulent transfer provisions to be applied on an extraterritorial basis. On January 4, 2016, in the *Lyondell* bankruptcy case, Judge Robert Gerber of the Bankruptcy Court for the Southern District issued a contrary decision, holding that the Bankruptcy Code's grant of jurisdiction to bankruptcy courts over the debtor's property "wherever located" was sufficient to authorize avoidance and recovery of extraterritorial transfers. In light of the apparent split between two lower courts on this critical question regarding the reach of the Bankruptcy Code, we expect the Second Circuit to address the issue of extraterritoriality in due course.

<u>Power of Bankruptcy Courts</u>

Following up on its landmark ruling in *Stern* v. *Marshall*, which held that bankruptcy judges have limited authority under Article III of the Constitution to determine claims asserted by an estate against creditors (*see* memo of June 27, 2011), the United States Supreme Court ruled in May that litigants can consent to bankruptcy court adjudication of their claims. *Wellness Int'l Network, Ltd.* v. *Sharif*, No. 13-935 (May 26, 2015). The decision adheres to *Stern*'s core holding that bankruptcy courts generally lack power to enter final judgments on state law claims against creditors. Nonetheless, *Wellness* makes clear not only that authority to resolve those claims can be conferred through consent, but also that litigants wishing to preserve their right to an Article III forum must be vigilant in expressly refusing consent to bankruptcy court adjudication. Our memo dated May 27, 2015 discusses the ruling in detail.

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